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UNCLAS SECTION 01 OF 02 BRASILIA 001662

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TREASURY FOR OASIA - DAS LEE AND FPARODI
STATE PASS TO FED BOARD OF GOVERNORS FOR ROBITAILLE
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E.O. 12958: N/A
TAGS: ECON EFIN
SUBJECT: BRAZIL - ECONOMIC GROWTH AND INFLATION SLOW

REF: A) BRASILIA 1456
B) BRASILIA 521
C) BRASILIA 1631
D) BRASILIA 682

¶1. (SBU) Summary: Brazil's economy slowed more sharply than expected in the first quarter, clocking growth of 0.3%. Growth expectations for the year, therefore, are being downgraded, to the 2.5% to 3% range. The good news is that previously intractable inflation and inflationary expectations also have begun to fall, responding to the cycle of Central Bank interest rate increases begun in September 2004. This allowed the Central Bank's Monetary Policy Committee (COPOM) to leave interest rates unchanged at its June 14-15 meeting, after an eight-month adjustment cycle that increased the bank's overnight rate (the SELIC) from 16% to 19.75%. With growth settling back towards what many believe to be the maximum sustainable level in the medium term (about 3%), the economic policy focus shifts to reforms to increase the economy's productivity, and thereby its growth potential. The current scandal over vote-buying in Congress (ref C), however, will make even more difficult Congressional approval of President Lula's reform agenda. End Summary.

¶2. (SBU) Economic growth slowed more quickly than anticipated in the first quarter of 2005, according to GoB data. The quarterly growth data (see table below) show, on the demand side, declines in investment and private consumption. These are reflected on the supply side in a 1% drop in industrial output for the quarter. Taken together, the data suggest that the Central Bank's monetary tightening has been slowing growth, reducing investment, personal consumption and industrial output. Despite the current drought in southern Brazil, the data also show surprisingly strong growth in agricultural output. According to Carlos Mussi, an economist with the UN Economic Commission for Latin America (ECLAC), the drought's impact will only begin to show up in data for the second quarter. Exports turned in another gravity-defying performance despite the appreciation of the Real (ref A).

Brazilian GDP
Percent Growth - Seasonally Adjusted

	Annual/1		Quarterly Growth/2			
	2003	2004	2Q04	3Q04	4Q04	1Q05
Total GDP	0.5	4.9	1.1	1.3	0.4	0.3
Supply Side						
- Agriculture	5.0	5.3	0.5	-1.6	1.8	2.6
- Industry	-1.0	6.2	1.0	2.6	0.4	-1.0
- Services	-0.1	3.3	1.0	0.9	0.4	-0.2
Demand Side						
- Consumption (Private)	-3.3	4.1	1.6	1.3	0.8	-0.6
- Govt.	0.6	0.1	-1.0	1.3	0.5	-0.1
- Investment	-6.6	10.9	3.5	6.2	-3.9	-3.0
- Exports	14.2	18.0	4.1	2.1	3.3	3.5
- Imports	-1.9	14.3	1.4	4.2	3.2	2.3

/1 Percent Change on Previous Year
/2 Percent Change on Previous Quarter, Preliminary
Source: Statistics and Geographic Institute (IBGE)

¶3. (SBU) Analysts, who previously were predicting growth of 3.5% to 4% for 2005, have been busily revising their growth projections downward. The GoB's Institute for Applied Economic Research (IPEA) now is projecting growth of 2.9% in
¶2005. The latest Central Bank survey of market expectations, which averages the predictions of financial institutions with economic models, shows the market is predicting growth of 3.1% for the year. The IMF Resident Representative told Econoff he expects growth of 2.75% to

3%.
¶4. (SBU) The Brazilian Geographic and Statistical Institute (IBGE), which produces the official growth and inflation numbers, also revised downward its initial estimate of growth last year from 5.2% to 4.9%. Mussi explained to Econoff that after receiving additional data from the GoB's telecommunications regulatory agency, the IBGE re-estimated the growth in telecommunication services, and made other lesser adjustments. While Mussi expressed some doubt about the precision of the IBGE estimates -- in particular their methodology for seasonal adjustments -- it was clear, he said, that the economy would expand less robustly than before.

¶5. (SBU) The good news is that, along with slowing the economy, Central Bank interest rate increases finally look to be bringing stubborn inflation and inflationary expectations under control. Inflation as measured by the consumer price index (IPCA) dropped from 0.87% in April to 0.49% in May. Inflationary expectations likewise have moderated. Since the beginning of May, Central Bank surveys have shown market expectations for inflation consistently falling. The market now predicts 2005 annual inflation of 6.16% (down from 12.5% in 2002, 9.3% in 2003 and 7.6% in 2004). While this is well above the 5.1% target, it remains well within the 2.5 percentage point band on either side of the target. Based on this shifting inflation scenario, the Central Bank halted its eight-month cycle of interest rate increases, voting at its June 14-15 meeting to keep the benchmark SELIC rate at 19.75%. Mussi noted that although inflation was clearly headed in the right direction, structural rigidities and credit expansion (ref D) were increasing the cost of marginal reductions in inflation.

¶6. (SBU) Comment: As GDP growth settles towards 3% -- within the ballpark of what most analysts believe is, in the medium term, the economy's maximum sustainable expansion rate -- this cycle of monetary tightening has made clear the need to move forward with badly needed reforms (ref B). While it is still early to draw firm conclusions, the current political scandal over alleged Lula administration vote-buying in the Congress (ref C) looks to have made the GoB's already modest reform ambitions for the year (ref B) even harder to achieve.

DANILOVICH